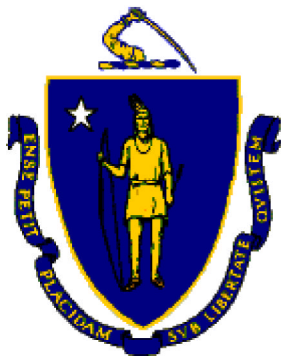


Introductory Section



THIS PAGE LEFT INTENTIONALLY BLANK



*William Kilmartin,
Comptroller
One Ashburton Place
Boston, MA 02108*

December 11, 1997

***To the Citizens of the Commonwealth of Massachusetts,
Governor Argeo Paul Cellucci, and Honorable Members of the General
Court***

It is with great pleasure that I transmit the Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 1997 (FY97). This is the twelfth time we have reported the Commonwealth's financial results in accordance with generally accepted accounting principles (GAAP). I am pleased to report that the financial condition of the Commonwealth is excellent.

For the seventh consecutive year revenues have exceeded expenditures by a significant amount. It was not long ago, in FY90, that the Commonwealth reported in the Budgeted Funds a GAAP deficit balance of \$1.9 billion. We now report a positive GAAP balance in these funds of \$1.1 billion. Years of prudent fiscal management, characterized by structurally balanced budgets, combined with a favorable economy, have caused this turnaround. The Commonwealth's strategic reserve, called the Stabilization Fund, is now funded in the amount of \$799.3 million. In addition, \$91.8 million has been reserved for income tax reduction in FY98. In FY90 and FY91, the Commonwealth resorted to over \$1.8 billion in deficit borrowing. Conversely in FY97 each individual taxpayer received a tax reduction averaging \$43, and the deficit borrowing will be completely repaid in early FY98. The ongoing challenge to state policy makers is to sustain this excellent financial condition.

The Office of the Comptroller is responsible for the fair presentation of the financial statements of the Commonwealth and for the preparation of this Comprehensive Annual Financial Report which is presented in three sections: Introductory, Financial, and Statistical. The three sections of the CAFR, as detailed in the table of contents, include the information necessary for the reader to obtain a comprehensive understanding of the Commonwealth's financial position and the results of its operations for FY97.

The CAFR is prepared in accordance with GAAP as established by the Governmental Accounting Standards Board (GASB), the professional standards of the American Institute of Certified Public Accountants (AICPA), the recommendations of the Government Finance Officers Association (GFOA), and the requirements of state finance law.

In FY97 the Commonwealth implemented two new GASB statements:

- Statement No. 28 "Accounting and Financial Reporting for Securities Lending Transactions"; and
- Statement No. 30 "Risk Financing Omnibus".

This implementation had no material effect on the Commonwealth's financial statements.

BUDGETED FUNDS OPERATIONS

The portion of state finances that typically engenders the highest degree of interest is the Budgeted Funds. These include the General, Local Aid, Highway, and certain Special Revenue Funds which comprise the annual state budget.

Budgeted Funds Operations - GAAP Basis

(Amounts in millions)

	FY93 ⁽¹⁾	FY94	FY95	FY96	FY97
Beginning fund balances (deficits).....	\$ (317.4)	\$ (184.1)	\$ (72.0)	\$ 287.4	\$ 709.2
Equity transfer	-	-	91.0	-	-
Restated beginning balance (deficit).....	(317.4)	(184.1)	19.0	287.4	709.2
Revenues and other financing sources.....	15,181.0	15,804.9	16,517.5	17,524.6	18,845.9
Expenditures and other financing uses.....	15,047.7	15,692.8	16,249.1	17,102.8	18,458.8
Excess	133.3	112.1	268.4	421.8	387.1
Ending fund balances (deficits).....	\$ (184.1)	\$ (72.0)	\$ 287.4	\$ 709.2	\$ 1,096.3

(1) As restated to reflect discrete presentation of the University and College Fund.

Budgeted Funds Operations - Statutory Basis

(Amounts in millions)

	FY93	FY94	FY95	FY96	FY97
Beginning fund balances	\$ 549.4	\$ 562.5	\$ 589.3	\$ 726.5	\$ 1,173.0
Revenues and other financing sources.....	15,205.7	15,979.2	16,930.8	18,371.4	19,223.3
Expenditures and other financing uses.....	15,192.6	15,952.4	16,794.1	17,924.9	19,002.3
Excess	13.1	26.8	136.7	446.5	221.0
Ending fund balances.....	\$ 562.5	\$ 589.3	\$ 726.5	\$ 1,173.0	\$ 1,394.0

The table of Budgeted Funds Operations - GAAP Basis sets forth a multi-fiscal year view of financial performance for the Budgeted Funds under GAAP, and also provide a comparison to the same funds as accounted and reported under the statutory basis of accounting.

On the statutory basis of accounting, which is used to develop the Commonwealth's budget and control its daily activities, the Budgeted Funds have achieved positive ending fund balances for each of the years, increasing this fund balance from \$562.5 million in fiscal year 1993 to \$1,394.0 million in the current fiscal year for a cumulative improvement of \$831.5 million.

Over the same period on a GAAP basis, operating gains have improved fund balance from a deficit \$184.1 million to a positive \$1,096.3 million, with cumulative improvement of \$1,280.4 million. Simply stated, the widely acknowledged efforts to accomplish fiscal balance on a statutory basis are even more impressive when viewed on a GAAP basis.

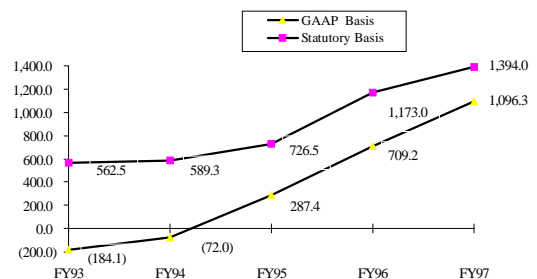
The basic principle of GAAP is to match inflows pertaining to the fiscal year to outflows for the same period in order to demonstrate if the objective of interperiod equity has been accomplished. A modified accrual basis of accounting is employed to recognize certain assets and liabilities. Accomplishment of interperiod equity is denoted by an increase in fund balance, and the failure to accomplish that goal is denoted by a decrease in fund balance. The effect of fund deficits shifts the burden of funding expenditures incurred in prior years to taxpayers in future years. The Commonwealth has provided not only revenues to match expenditures in the current year, but also excess revenues to "catch up" on prior year deficits.

In FY97, the revenues and other financing sources totaled \$18,845.9 million. The Budgeted Funds - GAAP Basis chart shows the percentage of revenue by type contributing to that total. Budgeted Funds expenditures and other financing uses totaled \$18,458.8 million in FY97. The chart depicts the percentage of each major program in this total.

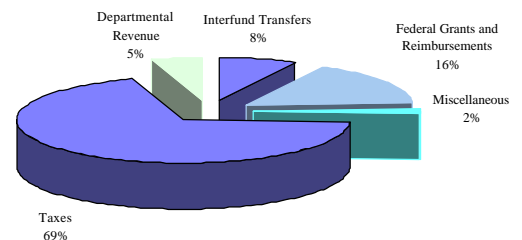
There are five major items that account for almost all the difference between the statutory basis reporting and GAAP: Medicaid, subsidies to authorities, compensated absences, claims and judgments, and tax revenues.

For the Medicaid program, expenditures under the statutory basis of accounting are equivalent to cash disbursements. Thus bills for services rendered in the fiscal year but not paid, or rate adjustments owed but not paid, are not measured in that year, but "pushed" into the next fiscal year. Under GAAP, such items are accrued, so that all expenditures are consistently correlated to the fiscal year to which they pertain. The Medicaid expenditures measured on a GAAP basis for FY97 were \$3,497.3 million, which is 7.9% higher than FY96. This increase is equivalent to the increase for total budgeted expenditures from FY96 to FY97. For several years the Commonwealth aggressively pursued policy to constrain expenditure growth in Medicaid, thus helping to balance the overall budget. In FY97, the Commonwealth authorized expanded programs and services with increased spending. (The financial effect of this policy change will be more evident in FY98.)

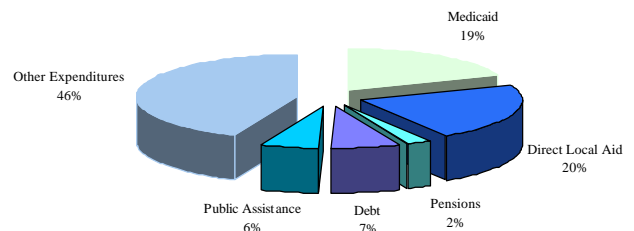
Trends in Fund Balance (Amounts in millions)



BUDGETED FUNDS - GAAP BASIS Revenue and Other Financing Sources



BUDGETED FUNDS - GAAP BASIS Expenditures and Other Financing Uses



A second item is the amount the Commonwealth will owe for subsidies to the Massachusetts Bay Transportation Authority (MBTA), the Regional Transit Authorities (RTAs), and the Massachusetts Convention Center Authority (MCCA). Through various laws the Commonwealth has obligated itself to provide subsidies to these component units for operations and debt service. However, the annual budget is appropriated on a basis which “lags” behind the total amount of the subsidy. Under GAAP, this amount is accrued, so that the total obligation is measured. For many years the amount for the “not yet appropriated” subsidy was growing at rates higher than the total budget.

However, in recent years this trend has varied, and in FY97 the amount accrued for MBTA subsidy obligations increased from FY96 by \$40.1 million. A special commission, chaired by the Secretary of Administration and Finance and with twelve entities represented, completed a study and made recommendations to the Legislature on matters relating to the MBTA subsidy. This MBTA Commission proposed significant changes to fund the subsidy on a contemporaneous basis so that financial support for the MBTA would not “lag”, but the recommendations were not enacted.

The third item is compensated absences. Under GAAP, the amounts owed for vacation earned but not yet taken and certain amounts of sick leave are accrued and reported as expenditures of the fiscal year. The trend for compensated absences has been relatively consistent.

The fourth item is claims and judgments. Under the statutory basis, amounts owed in lawsuits for torts, tax disputes, eminent domain land taking, or other legal actions are not measured as expenditures until the lawsuit is decided and the settlement is actually paid. Under the GAAP basis, an analysis is performed on all litigation, and an amount is accrued for that portion of litigation where a settlement against the Commonwealth is considered probable.

The fifth item that explains the difference between statutory and GAAP relates to tax revenue. For several reasons, as an example the extension of an income tax return, a taxpayer’s obligation incurred in a fiscal year might not be fully collected until the ensuing fiscal year. Under GAAP, a special analysis is conducted in conjunction with the Department of Revenue (DOR), and an accrual for revenue is computed. The value of accrued revenue was \$514.6 million in FY97.

GOVERNMENTAL FUND OPERATIONS

The Governmental Fund Types include all funds where the Commonwealth imposes its sovereign authority to create revenues and authorize expenditures. This includes all Budgeted Funds as previously described (General and several Special Revenue Funds), all other (non-budgeted) Special Revenue Funds, and the Capital Project Funds. When viewed as a whole, these funds portray the Commonwealth’s comprehensive governmental financial activity. The five year trend of operations, on a GAAP basis, is summarized in the following table.

Within the Capital Projects Funds component of the Governmental total, the Commonwealth issued approximately \$373.5 million in project financing in early FY98 instead of late FY97. Had such capital project financing been issued in FY97, the Governmental Funds positive fund balance would have increased by an equivalent amount.

Governmental Fund Operations

(Amounts in millions)

	FY93 ⁽¹⁾	FY94	FY95	FY96	FY97
Beginning fund balances (deficits).....	\$ (416.8)	\$ (478.3)	\$ (273.7)	\$ (16.3)	\$ 644.6
Equity transfer	-	-	15.5	-	-
Restated beginning balance (deficit).....	(416.8)	(478.3)	(258.2)	(16.3)	644.6
Revenues and other financing sources.....	22,380.3	23,226.0	24,216.4	25,102.3	27,372.9
Expenditures and other financing uses.....	22,441.8	23,021.4	23,974.5	24,441.4	26,986.9
Excess (deficiency).....	(61.5)	204.6	241.9	660.9	386.0
Ending fund balances (deficits).....	<u>\$ (478.3)</u>	<u>\$ (273.7)</u>	<u>\$ (16.3)</u>	<u>\$ 644.6</u>	<u>\$ 1,030.6</u>

(1) As restated to reflect discrete presentation of the University and College Fund.

INTERNAL SERVICE FUNDS

In FY95, consistent with adoption of GASB statement No. 10 "Accounting and Financial Reporting for Risk Financing and Related Insurance Issues", the Commonwealth established for GAAP reporting purposes three Internal Service Funds. These funds account for the operations of the State Employees Workers' Compensation Program, a special workers compensation program for the Central Artery/Third Harbor Tunnel Project, and for the health insurance programs administered by the Group Insurance Commission. On the statutory basis of accounting these funds have not been created and are not reported. The adjusting entries to report these "GAAP only" Funds represent another difference from the statutory basis.

The Commonwealth self-insures for the State Employees Workers' Compensation Program. This program was administered by the Public Employee Retirement Administration Commission (PERAC) through FY97. Effective July 1, 1997 administration has been transferred to the Human Resource Division. Inflows to the program are amounts charged to state departments; outflows are expenses for claims and settlements, and accrued expenses for claims which will be paid in the future. The traditional policy has been to set chargebacks equivalent to claims paid, typically referred to as a "pay as you go" approach. As a result, an unfunded liability of \$251.2 million has accumulated. The Commonwealth should consider a plan to increase annual chargebacks, thus eventually funding such liability.

In regard to the Central Artery/Tunnel Project, the Executive Office of Transportation and Construction, with the approval of the U.S. Department of Transportation, has created a special workers

compensation program to cover all participants (including employees of contractors) on the project. In this arrangement, annual premiums and investment earnings are accumulated by the insurance carrier to fund current and future claims. The approach is expected to diminish this potentially expensive component of the large, multi-year construction project. With four years experience, it is evident that amounts contributed to the program significantly exceed the expectations of current and future benefits. With this situation (the opposite of the State Employees Workers' Compensation Program), the Executive Office of Transportation and Construction should consider a plan to decrease annual premiums, and thus lower the accumulated balance, on a go-forward basis. The respective contributions of both state and federal governments must be considered in any change to this program.

The Group Insurance Commission manages the health insurance program for state employees, retirees, and their beneficiaries. Inflows to the program are amounts contributed by individuals, participant organizations, or by the Commonwealth; and outflows are expenses for claims, plus an amount of accrued expenses for claims incurred but not reported. The accumulated balance, while a small deficit, is not material to the size of the program, suggesting that symmetry of inflows to outflows is reasonable and change is not warranted.

The operations of the Internal Service Funds are depicted in the Internal Service Fund Operations chart. The ending retained earnings consists of deficits of \$251.2 million and \$34.2 million in Employees Workers' Compensation and Employees Group Health Insurance offset by \$145.1 million in the Central Artery Workers Compensation program.

Internal Service Fund Operations
(Amounts in thousands)

	FY95	FY96	FY97
Beginning Retained Earnings (Deficit).....	\$ -	\$ (223,419)	\$ (151,080)
Operating Gain.....	127,932	68,664	3,234
Other Revenues	5,985	3,675	7,508
Equity Transfer.....	(15,716)	-	-
Balance from the General Long Term Obligations.....	(341,620)	-	-
Ending Retained Earnings (Deficit).....	<u>\$ (223,419)</u>	<u>\$ (151,080)</u>	<u>\$ (140,338)</u>

FIDUCIARY FUND OPERATIONS

The Fiduciary Fund Type reports funds where the Commonwealth is acting as an agent or steward for funds which relate to another party. The Fiduciary Fund Type includes the Expendable Trust, Nonexpendable Trust, Pension Trust, and Agency Funds.

The Nonexpendable Trusts account for assets held with restrictions and the Agency funds account for assets managed temporarily on behalf of other parties. The amount of such assets managed by the Commonwealth increased by \$756.4 million during FY97 to \$7.0 billion.

The Expendable Trusts ended FY97 with a fund balance of \$1.6 billion composed of a balance of \$116.4 million in Expendable Trusts and \$1,515.0 million in the Unemployment Compensation Trust Fund.

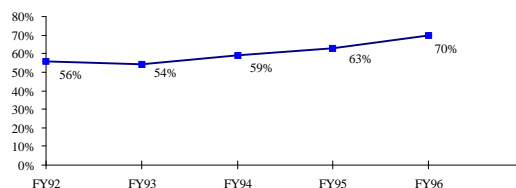
The Commonwealth is responsible for the payment of pension benefits to its employees and to the teachers of the cities, towns, and regional school districts. It manages the operations of both the State Employees' Retirement System (SERS) and Teachers' Retirement System (TRS), and reports the results of operations and net assets available to fund pension benefit as Pension Trust funds. Pursuant to the pension reform law, effective in FY88, the Commonwealth is funding its pension liabilities on a long term schedule. The original schedule would have eliminated the unfunded pension liability in 40 years, by the year 2028. A new funding schedule approved in FY97 will eliminate the unfunded pension liability in 30 years by the year 2018. It is the responsibility of the Public Employee Retirement Administration (PERA) to complete actuarial updates for the funding schedule.

In FY97, PERA was reorganized in statute to the Public Employee Retirement Administration Commission (PERAC), but retains the responsibility for actuarial updates. Also in FY97, the investment vehicles for all pension funds (state employee and employer amounts, and teacher employee and employer amounts) were unified into a single investment entity, under the management of the Pension Reserve Investment Management Board (PRIM). The actuarial report for SERS, TRS, and for the State-Boston Retirement System was published by PERA as of January 1, 1996.

In FY96 the Commonwealth adopted the provisions of GASB Statement Numbers 25 and 27 which changed the measurement focus of funding progress. The [Pension Funding Progress Graph](#) presents the funding progress applied under the prior standards while the funding progress under the new standards are disclosed in footnote 10.

The following table presents a five-year trend analysis of the Pension Trust Funds operations:

**Pension Funding Progress
Funded Ratio**



Pension Trust Funds
(Amounts in millions)

	FY93	FY94	FY95	FY96	FY97
Beginning fund balances	\$ 9,648.6	\$ 11,121.1	\$ 11,563.1	\$ 13,483.2	\$ 15,956.2
Revenues.....	2,374.2	1,376.3	2,902.1	3,560.6	4,729.4
Expenses.....	901.7	934.3	982.0	1,087.6	1,125.6
Excess	1,472.5	442.0	1,920.1	2,473.0	3,603.8
Ending fund balances.....	<u>\$ 11,121.1</u>	<u>\$ 11,563.1</u>	<u>\$ 13,483.2</u>	<u>\$ 15,956.2</u>	<u>\$ 19,560.0</u>

UNIVERSITY AND COLLEGE FUND TYPE

Since FY93 the CAFR has presented the University and College system in accordance with the AICPA Industry Audit Guide, "Audits of Colleges and Universities." This presentation combines financial activity from all fund types for:

- the University of Massachusetts, including its campuses at Amherst, Boston, Dartmouth, Lowell, Worcester Medical School, and the Teaching Hospital as well as its component units.
- the State College system of nine state colleges, which provide four-year post-secondary education, and the State College Building Authority.
- the Community College system of fifteen community colleges which provide two-year post-secondary education programs.

The University and College Fund Type reports a positive GAAP fund balance. Approximately \$2.4 billion of this fund balance is restricted or designated in plant funds, endowment funds, or other purposes.

University and College Fund Type Operations

(Amounts in millions)

	FY93	FY94	FY95	FY96 (1)	FY97
Beginning fund balances.....	\$ 1,991.6	\$ 2,010.4	\$ 2,034.9	\$ 2,164.9	\$ 2,363.3
Revenues and other additions.....	1,329.2	1,449.5	1,536.7	1,816.6	1,823.7
Expenditures and other deductions.....	1,881.3	2,006.4	2,082.0	2,254.4	2,381.8
Net transfers, including state appropriations.....	570.9	581.4	601.6	636.2	707.0
Net Increase	18.8	24.5	56.3	198.4	148.9
Ending fund balances.....	\$ 2,010.4	\$ 2,034.9	\$ 2,091.2	\$ 2,363.3	\$ 2,512.2

(1) As restated for addition of component units

In FY97, fourteen of these entities are commended for producing stand alone audited financial reports in conformity with Generally Accepted Accounting Principles. This list includes Holyoke Community College, Massasoit Community College, Mass Bay Community College, Springfield Technical Community College, Bridgewater State College, the Massachusetts College of Art, Framingham State College, Fitchburg State College, Middlesex Community College, Mount Wachusett Community College, Northern Essex Community College, Westfield State College, Worcester State College, and the University of Massachusetts. Each of these schools has demonstrated accountability to its trustees, the Governor and Legislature, and to all concerned parties with audited financial statements prepared in accordance with GAAP.

For several years both the Comptroller's Office and the Board of Education (previously the Higher Educational Coordinating Council) have encouraged all schools as a matter of policy to commit the requisite resources and effort to produce stand alone audited financial statements. The University of Massachusetts is an excellent example of the successful implementation of this policy, as it reported very favorable financial performance in FY97. In the FY97 appropriation act the Legislature authorized the institutions of higher education to create component units, called Foundations, to assist in fund raising for public education. As part of this authorization, the legislation requires each Foundation to produce audited financial statements. In the current legislative session, the Office of the Comptroller and the Board of Higher Education has requested the Governor to file legislation to extend the statutory requirement for stand-alone financial statement audits in conformity with GAAP beyond the Foundations to the respective institutions.

COMPONENT UNITS

The Commonwealth's relationship to the independent public authorities, reported as Component Units, is based on statute and contracts between the Commonwealth and these entities.

Component Units Operations

(Amounts in millions)

	Beginning Retained Earnings	Operating Gain/ (Loss)	Subsidy	Other Changes	Ending Retained Earnings
Massachusetts Bay Transportation Authority.....	\$ (204)	\$ (545)	\$ 617	\$ (59)	\$ (191)
Massachusetts Turnpike Authority.....	358	(5)	-	4	357
Regional Transit Authorities.....	2	(79)	56	23	2
Massachusetts Water Pollution Abatement Trust.....	30	(9)	26	24	71
Massachusetts Convention Center Authority.....	-	(12)	17	(2)	3
Corporation for Business Work and Learning*.....	8	(48)	9	40	9
Government Land Bank.....	31	(5)	2	-	28
Massachusetts Community Development Finance Agency.....	2	(1)	1	-	2
Massachusetts Technology Park Corporation.....	19	(2)	1	-	18
Community Economic Development Assistance Corporation.....	39	5	-	1	45
Massachusetts Corporation for Educational Telecommunication....	4	(8)	5	3	4
Massachusetts Housing Partnership.....	14	3	2	(5)	14
Commonwealth Zoological Corporation.....	(1)	(3)	3	2	1
Massachusetts International Trade Council.....	-	(1)	1	-	-
Total.....	<u>\$ 302</u>	<u>\$ (710)</u>	<u>\$ 740</u>	<u>\$ 31</u>	<u>\$ 363</u>

* Formerly Bay State Skills and the Industrial Service Program

INDEPENDENT AUDIT

The firm of Deloitte & Touche LLP, together with subcontractors Daniel Dennis & Company, Margaret Carr, CPA and Susan Perna-Damon, CPA, and assisted by the Office of the State Auditor, have performed an independent audit of the Commonwealth's general purpose financial statements for the fiscal year ended June 30, 1997. We express our thanks to the staff of the respective firms for their professionalism, advice and counsel. Their report is presented in the Financial Section.

INTERNAL CONTROL ENVIRONMENT

Massachusetts General law, Chapter 647 of the Acts of 1989, places authority and responsibility for internal controls with the head of each executive department, constitutional office, and branch of government. The Office of the Comptroller issues internal control guidelines and the Office of the State Auditor may investigate departments with risk of internal control weaknesses.

These two offices have continued to deliver joint training sessions for department managers regarding their responsibility for internal control in the Commonwealth's highly automated environment.

Absolute assurance with respect to internal control is prohibitively expensive. Using risk assessment criteria set forth in the guidelines and stressed in the training, the objectives of the Commonwealth's internal control structure are to provide management and the public with reasonable assurance that internal control systems do not have material weaknesses. The reader is referred to the separately published Commonwealth Single Audit Reports for additional information on internal controls.

REPORTING ENTITY

The financial statements incorporate the fiscal activities of 146 departments, agencies, boards, commissions, institutions of higher education, the judicial and legislative branches of government, and constitutional offices. These departments record their daily financial operations in the state accounting system called the Massachusetts Management Accounting and Reporting System (MMARS), operated by the Office of the Comptroller.

In addition, the financial statements include independent public authorities, and the State Employees' and Teachers' Retirement Systems. These component units meet the GAAP criteria for inclusion in the reporting entity, which are further described in Note 1 to the general purpose financial statements.

ACCOUNTING SYSTEM AND BUDGETARY CONTROL

MMARS is the computerized, statewide accounting system used by all departments to control and account for their financial activity under the statutory basis of accounting. The financial operations of the authorities and certain non-appropriated higher education funds are accounted for through their own independent accounting systems.

MMARS is designed to satisfy all requirements of the Commonwealth's statutory basis of accounting and financial reporting. Any additional information needed to prepare financial statements according to GAAP is provided through a combination of MMARS system-generated data, information compiled by departments, and the submission of audited financial statements from certain independent authorities.

Note 2 to the general purpose financial statements provides a reconciliation between the General and Budgeted Special Revenue Funds on a statutory basis and the GAAP basis presented in the general purpose financial statements.

CASH AND INVESTMENTS

Cash and investments are controlled by the State Treasurer. Each department transmits all cash receipts to the Treasurer's Office. Weekly and daily warrants for disbursements are prepared by the Comptroller, and reviewed and approved by the Governor's Council; disbursements are issued by the Treasurer. A major project is underway to streamline the banking and disbursement process, and maximize use of electronic funds transfer and electronics benefits transfer.

A system of bank depository and disbursement accounts and lockboxes is employed by the Treasurer's Office to maximize daily cash balances. The Treasurer manages these cash balances in pooled investment funds to optimize interest earnings. The Treasurer's Office invests cash from these general accounts in short-term securities and other investments. A discussion of cash and investments is presented in Note 3 to the general purpose financial statements.

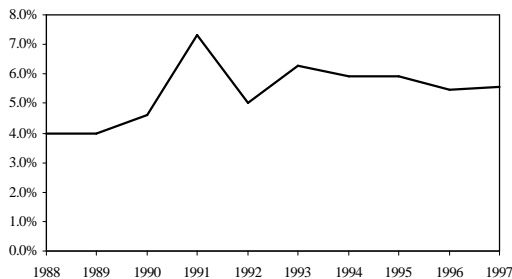
The Treasurer is also responsible for quarterly cash flow plans, weekly variance reports, and, jointly with the Executive Office for Administration and Finance, annual and quarterly cash management plans. Taxes and non-tax inflows, warrants, other outflows, and short and long-term borrowings are monitored against these plans.

FY97 is the fourth year of the Commonwealth's implementation of the U.S. Cash Management Improvement Act (CMIA). The CMIA requires the states to measure interest income on federal funds drawn from the U.S. Treasury prior to disbursement, and for the U.S. Treasury to measure interest income on funds drawn down subsequent to disbursement. A settlement of interest due to or due from the state and federal government is computed. For FY97, the net settlement is in favor of the Commonwealth.

Long-Term Debt
(Amounts in billions)

Fiscal Year	Authorized - Unissued	Principal Outstanding
1997	12.0	\$ 10.3
1996	8.2	10.1
1995	5.9	9.6
1994	4.5	9.4
1993	4.6	9.2

Debt Service as a % of Governmental Expenditures



DEBT

The Commonwealth funds its capital appropriations by authorizing the issuance of long-term bonds. The Long Term Debt chart sets forth the trend of the Commonwealth's tax-supported long-term indebtedness for the last five years.

To limit the Commonwealth debt burden, and control the degree to which debt service creates pressure on the operating budget, the Administration has implemented a five-year capital spending plan. This administrative policy has existed for several years, and the effect of debt service on the operating budget is depicted on the following graph of Debt Service as of % of Governmental Expenditure.

In October, Standard and Poors upgraded, the rating for Commonwealth's General Obligation Debt from "A+" to "AA-". The effect of the capital policy, the acceleration of funding of the Commonwealth's pension liability, and the string of operating surpluses were cited as reasons for the upgrade.

As authorized by state finance law, the State Treasurer may utilize short-term borrowing to support governmental cash flow. No such borrowings occurred during the fiscal year.

Other debt consists of certificates of participation and capital lease agreements. Such financing arrangements are used to acquire capital assets, for example computer equipment and motor vehicles. The Commonwealth continued to utilize this form of financing in FY98.

Additional information on Commonwealth debt, including guaranteed debt of independent public authorities, is presented in Notes 7, 8, and 12 to the general purpose financial statements.

RISK FINANCING

The Commonwealth assumes the risk of loss for property damage and personal injury, breach of contract, condemnation proceedings, and other alleged violations of law, and is defended by the Attorney General's Office in such cases. In FY97, approximately \$23.0 million was expended to resolve such claims in special and existing appropriations. Based on the Attorney General's evaluation of cases in which it is probable that a judgment will be rendered against the Commonwealth, and a loss incurred, an additional \$66.7 million has been accrued in the Governmental Funds at June 30, 1997.

ECONOMIC AND FINANCIAL PROSPECTS

Massachusetts employment grew 2.2% in 1994, 0.9% in 1995 and 1.1% in 1996. The Massachusetts unemployment rate, currently at 3.7%, remains below the national rate of 4.7% (October 1997). Commonwealth per capita income continues to outpace the nation as shown in the Per Capita Income graph.

The Commonwealth of Massachusetts, with an international reputation for medical, cultural, historical, and educational institutions, is the economic and educational hub of New England. The Commonwealth's economy remains diversified but its strongest component is its knowledge-based technology and service industries.

Massachusetts' infrastructure provides strong support for this knowledge-based economy. There are over 120 colleges and universities located in Massachusetts, and 27.2% of the residents over age 25 have earned bachelor's degrees, compared to 20.3% for the United States as a whole.

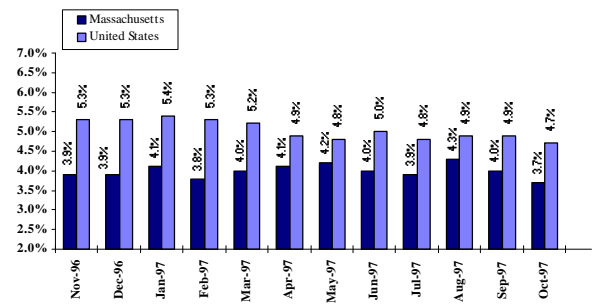
Our capital, Boston, has 25 hospitals and three medical schools. Tourism is a significant component of the economy. The Massachusetts Office of Travel and Tourism estimates that over 28.0 million visitors spent over \$6.1 billion in the Commonwealth in 1995. The Commonwealth ranked eleventh among states in exports with \$16.2 billion in 1996.

A continued low rate of inflation is expected to keep wage growth low and allow for slow-paced positive growth in the Massachusetts economy.

The Commonwealth's FY98 budget forecast is consistent with the economic trends presented above. Budgeted revenues and other sources, as estimated by the Executive Office for Administration and Finance, are currently projected at approximately \$18,386.9 million. The estimate assumes tax revenues will grow 2.6% above FY97 actual collections. However when this estimate is adjusted for tax cuts proposed by the Governor; coupled with a one time change in the way sales taxes are paid, the impact on FY98 will be a decrease of \$196 million and \$140 million respectively. Therefore actual FY98 collections are estimated at \$12,839 million, slightly below FY97 actual receipts.

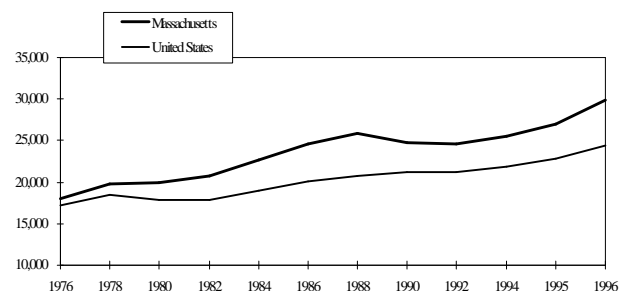
The Commonwealth's total budgeted expenditures and other uses in FY98 are projected at \$18,671.9 million. This estimate assumes the spending in the Commonwealth's seven major programs (Local Aid, Medicaid, Employee Health Insurance, Public Assistance, Debt Service, Pensions and Subsidies to Transit Authorities), which comprise over 60% of budgetary spending, will increase by 3.6% over FY97.

Monthly Unemployment Rate November 1996 - October 1997



Source: Massachusetts Department of Employment and Training

Per Capita Income 1976 - 1996 (in 1995 dollars)



The FY98 opening fund balance, for budgeted funds, on a statutory basis is \$1,394.0 million. If the FY98 forecast is realized, the ending fund balance will be approximately \$981.0 million. It is noteworthy that, of the \$981.0 million, approximately \$821.8 million is projected to be reserved in the Commonwealth's Stabilization Fund. In this forecast, the Commonwealth has continued a conservative revenue estimating approach. As in past years, ending fund balances may be higher due to this conservative approach to forecasting.

The Administration will soon be engaged in an extensive mid-year review of this estimate. The Governor will release his recommended budget for FY99 in late January, at which time the FY98 forecast may be revised.

SIGNIFICANT ACCOMPLISHMENTS

In FY97, there were a number of significant public policy accomplishments that demonstrate accountability and financial management.

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Commonwealth for its Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports. This is the seventh consecutive year that the Commonwealth has received this award.

The non-tax revenue optimization campaign was very successful in FY97. With special authorization in the budget, a task force was comprised of key persons from the Executive Office for Administration and Finance, the Budget Bureau, the Information Technology Division, and the Comptroller's Office. The task force provided leadership and sponsored projects by which outside experts were engaged on a contingent fee basis, and departments optimized various sources of non-tax revenue (such as federal reimbursement) by over \$39.1 million. The initiative is dedicated to optimizing all collection potential within the framework of existing fee structure and program authorizations. The non-tax revenue optimization campaign continues in FY98.

A large number of projects to enhance or re-engineer business processes with new technology have been performed. Such projects relate to an array of Commonwealth activities, including automation of welfare eligibility determination, management of cases in the legal system, creating a new statewide client server infrastructure, and significant changes to the Commonwealth's administrative and fiscal systems.

Examples of projects from the domain of financial accounting include: major streamlining of the Commonwealth's cash deposit and non-tax revenue systems; automation of the previously manual functions to exchange cash with the federal government; re-engineering the Commonwealth disbursement practices to the model of electronic commerce, including electronic data interchange, electronic funds transfer, and electronic benefits transfer; and creating a data warehouse to make the wealth of data emanating from transaction processing systems accessible and available to knowledge workers via query systems controlled by desktop computers.

Under the leadership of the Information Technology Division, several departments across the branches of government are collaborating in joint ventures to leverage resources in these projects. This approach is yielding significant results both in terms of shared functionality and interoperable systems, and increased purchasing power through joint procurements. Exciting partnerships with internal Commonwealth departments and private sector business partners have developed. Several of these projects have received national recognition and awards.

In early FY97, the Governor and Legislature enacted a second Information Technology Capital Outlay. This provides the funding and management framework for another series of projects that will exploit new technologies to improve the way the Commonwealth conducts its business. All these projects will be fully year 2000 compliant. In addition the project to update to the Commonwealth's accounting system for the year 2000 is scheduled for implementation in the fall of 1998. All Commonwealth's systems have year 2000 remediation projects in progress under the supervision of the Information Technology Division. With this innovative authorization technique and through its array of projects, the Commonwealth is again the focus of attention by other states, the U.S. Government, and the private sector. The prospects for future success are outstanding.

RECOMMENDATIONS AND CONCLUSIONS

The Office of the Comptroller has a unique perspective on state finance based on insights gained through control of day-to-day operations and experience with GAAP. With this background, we take this opportunity to make proposals intended to strengthen state finance.

Consistent with the prior recommendations, the Office of the Comptroller believes the Commonwealth's current fund structure should be streamlined. The Local Aid Fund has increased outflows associated with the Education Reform Act of 1994, and exhibits a structural budgetary imbalance. The continued existence of this Fund should be examined. The proliferation of budgeted Special Revenue Funds has fractured, not strengthened, the budget process.

As special interest groups have enjoyed political success in carving out dedicated revenues and removing operations from the general budget, the capacity for centralized planning and control has diminished. The numerous non-budgeted Special Revenue Funds and Capital Projects Funds further complicate efforts to obtain a comprehensive view of state finance.

The Office of the Comptroller has proposed Legislation to simplify the fund structure, reduce the number of funds to a more manageable number, and eliminate fund deficits.

In addition, the Office of the Comptroller has proposed legislation to simplify the definition of a balanced budget, and the terms and conditions for deposits into the Stabilization Fund. This legislation would result in a more coherent and understandable picture of the Commonwealth's Governmental Funds financial activity.

The Commonwealth has a tremendous opportunity to employ new technologies to improve its programmatic, financial, and administrative operations. In FY93 the Governor proposed and the Legislature enacted the first Information Technology Capital Outlay. In FY97, the Governor and Legislature enacted a second Information Technology Capital Outlay. With this funding the opportunity exists to re-engineer old business practices and engage new technology. An unprecedented interdepartmental coalition under the leadership of the Commonwealth's Chief Information Technology Officer creates an exciting opportunity to make strategic investments that will position the Commonwealth successfully into the next century. Consistent with this investment, the Comptrollers Office and Information Technology Division has requested changes to the budget to provide resources for ongoing systems operation and maintenance.

The Commonwealth has authorized and committed itself to a number of capital projects over the next several years. This includes the Central Artery/Tunnel project and several other initiatives that will generate significant pressure on the self-imposed cap on capital spending. In FY97 several mechanisms were established to address this situation, including utilization of approximately \$319.3 million from budgetary surplus for capital projects. Continued efforts and diligence to manage capital spending is merited.

The Commonwealth should enact a program to fund the liability for the State Employees Workers' Compensation Program as new costs are incurred and amortize the accumulated unfunded liability of \$251.2 million. This amount did not materialize in a single year and a multi-year funding schedule is recommended. Options to furnish the necessary funding include a "surcharge" to the current statutory chargeback to state agencies, special lump sum appropriations, a redirection of investment earnings, and other actions. Accumulating assets to satisfy the current unfunded liability will be another demonstration of interperiod equity and sound financial management. In contrast, for the special workers' compensation program for the Central Artery/Tunnel Project, the Commonwealth should consider decreasing annual contributions. In this instance, it appears the amount accumulated for current and future claims is more than adequate. Since both federal and state government contribute to the program, any change to annual contributions must be structured accordingly.

Regarding the institutions of higher education, the time has come for each school to produce audited stand-alone financial statements in conformity with generally accepted accounting principles. While many schools have moved into this practice of their own volition, and others are currently in the preparation process, it is appropriate to make this a statutory requirement. The Comptroller's Office and Board of Higher Education will seek legislation to accelerate such an effort.

In conclusion, this report represents the continued commitment of the Office of the Comptroller to promote quality in the Commonwealth's financial management. I express my sincere appreciation to the dedicated professionals in the Comptroller's Office, Martin Benison, B.J. Trivedi, and the staff of the Financial Reporting Bureau and other state departments and organizations whose efforts are reflected in this report.

In addition, the work of the several project teams to implement the Information Technology projects mentioned above is especially noteworthy. They are launched on projects that will create enduring value not only to Massachusetts, but to other states and governments throughout the nation. They exemplify the cutting edge of innovation, and the citizens of the Commonwealth are well served by professionals of their caliber.

The Office of the Comptroller transmits the Comprehensive Annual Financial Report for FY97 in accordance with Section 12 of Chapter 7A of the General Laws.

Respectfully transmitted,

A handwritten signature in black ink, reading "William Kilmartin". The signature is written in a cursive, flowing style.

William Kilmartin
Comptroller

CONSTITUTIONAL OFFICERS

Argeo Paul Cellucci
Governor

William F. Galvin
Secretary of State

L. Scott Harshbarger
Attorney General

Joseph D. Malone
Treasurer and Receiver-General

A. Joseph DeNucci
Auditor

LEGISLATIVE OFFICERS

Thomas F. Birmingham
President of the Senate

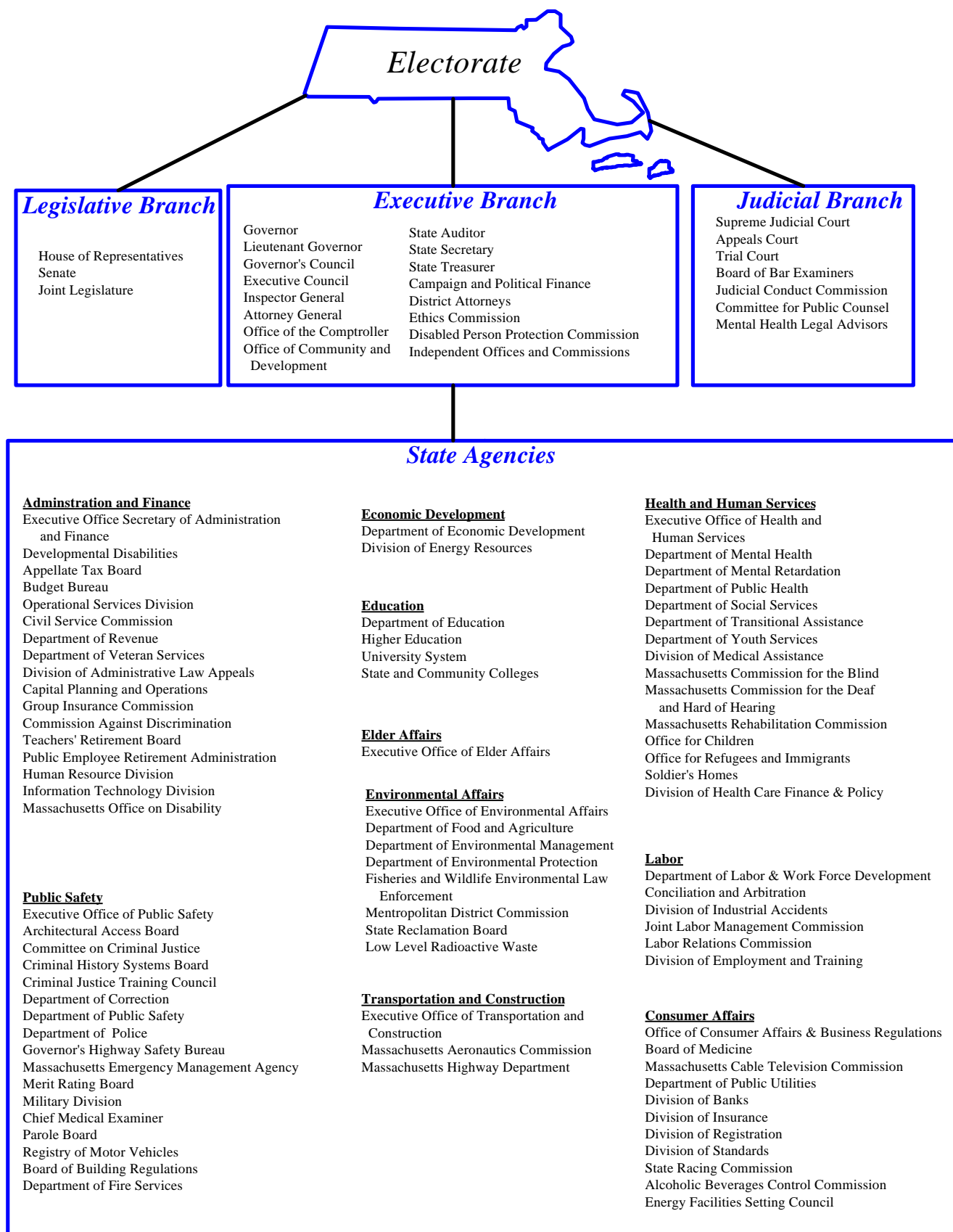
Thomas M. Finneran
Speaker of the House

JUDICIAL OFFICERS

Herbert P. Wilkins
Chief Justice, Supreme Judicial Court

Joseph P. Warner
Chief Justice, Appeals Court

John J. Irwin
Chief Justice for Administration and Management, Trial Court



REPORT PREPARED BY:

Martin J. Benison, CGFM
Deputy Comptroller

Anita Rose Rapino
Administrative Assistant

Financial Reporting And Analysis Bureau

Bhavdeep J. Trivedi, CGFM
Director

Marybeth Shaughnessy, CPA, CGFM
Assistant Director

John Haran, CPA, CGFM
Accountant

Pauline Lieu, CPA, CGFM
Accountant

Neil Gouse, CGFM
Accountant

Daryl E. Byers
Systems Analyst

Cathy DiGianni
Administrative Secretary

Padmanabh Patel
Intern

Ya Yee Chen
Intern

Michael Dunn
Intern

Lauren Johnson
*Director Resource Management
Layout and Design*

James Powers, CPA
Special Projects

Certificate of Achievement for Excellence in Financial Reporting

Presented to

Commonwealth of Massachusetts

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 1996

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



Linda K. Savitsky
President

Jeffrey L. Esser
Executive Director

3rd Congress

No. 1

Naval Force Against Algiers

"... the committee submit the following resolutions

Resolved, That a naval force, to consist of four ships of forty-four; and two ships of twenty guns, each, be provided, for the protection of commerce of the United States against the Algerine corsairs."

War Office, January 20, 1796

Sirs:

I have the honor to send, herewith, for the information of the committee to whom was committed the report on the frigates, the best returns of materials provided, and yet wanting, that can formed, together with an account of the moneys expended, and the sum necessary to complete, their construction and equipment, exclusively of men and provisions; this sum being estimated at \$453,973.

I am, very respectfully, sir, your obedient servant,

TIMOTHY PICKERING

Honorable Josiah Parker, Esq.

Both of the paragraphs above are from the transcripts of the 3rd Congress as communicated to the House of Representatives, January 20th, 1794. The first gives the approval to build a fleet, and the second, from the Secretary of War, records the cost estimate for the construction of four frigates including the U.S.S. Constitution.

The text was excerpted from the American State Papers, a chronicle of the first 34 congresses and the predecessor of the Congressional Informational Serial Set, an ongoing collection of U.S. Government publications compiled under the directive of Congress.